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Debt auction in Spain puts euro zone back on alert

MADRID

Borrowing costs soar, signaling 'new bout of nervousness' in market

BY RAPHAEL MINDER AND JACK EWING

A surge in borrowing costs for Spain on Wednesday unsettled financial markets and showed that even if the European debt crisis was in remission, it was not cured.

A decision by the European Central Bank on Wednesday to leave its main interest rate unchanged also reflected concerns about the broader euro zone, where the economy was sputtering and credit was still tight.

The Spanish debt auction came just days after the government of Prime Minister Mariano Rajoy announced deep budget cuts meant to reassure investors that Madrid could meet its deficit-reduction targets. Spain sold €2.6 billion, or $3.4 billion of debt, near the bottom of its targeted range. Yields were higher than in recent auctions as the government sought to counter falling demand amid concerns about the effects of the budget cuts on an economy that was sinking into its second recession in three years.

Following the disappointing bond auction, Spain's long-term borrowing costs soared to their highest levels since December, with the yield on the benchmark 10-year government bonds rising 25 basis points, or 0.25 percentage points, to 5.7 percent. It had fallen as low as 4.6 percent in January, when banks in Spain and elsewhere in the euro zone started to buy more government bonds, using the proceeds of low-interest loans provided by the European Central Bank.

"There has long been a dearth of foreign buyers, so if domestic buyers are now starting to retreat, the Spanish treasury has a serious problem on its hands," said Nicholas Spiro, founder of Spiro Sovereign Strategy, a London-based consulting firm specializing in sovereign credit risk. "I think this is beginning of a new bout of nervousness centered around Spain, but also possibly Italy."

In Europe, all major indexes fell 2 percent or more on Wednesday, with the Euro Stoxx 50, a barometer of European blue-chip stocks, slipping 2.5 percent and the FTSE 100 in London losing 2.3 percent. In Frankfurt, the DAX tumbled 2.9 percent.

U.S. stocks were trading lower Wednesday afternoon, with the Dow Jones industrial average down 1.1 percent and the Standard and Poor's 500-stock average off 1.2 percent.

The decision by the E.C.B. governing council to leave its benchmark rate at 1 percent, a record low, was expected. A rate increase would have signaled the central bank's intention to tamp down inflation in the 17-nation euro zone. At an annual rate of 2.6 percent in March, inflation is well above the E.C.B.'s target of about 2 percent. But any concerns policy makers may have had about prices were apparently outweighed by recent economic data showing that the euro zone

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economy was stuck in recession.

Unemployment in the euro zone reached its highest level in 15 years during February, according to data published Monday. In addition, recent surveys have shown that business managers have grown more pessimistic and that credit is difficult to come by, especially in countries like Spain that have been hardest hit by the debt crisis.

Spain's problems, including the disappointing results of Wednesday's debt auction, raised the possibility that the European sovereign debt crisis could accelerate again, and contributed to a sharp decline in main European stock indexes as well as the euro.

Asked at a news conference in Frankfurt about the Spanish bond auction, Mario Draghi, the president of the E.C.B., warned countries that they could be penalized if investors conclude they were wavering in efforts to cut spending and improve economic performance.

Financial markets "are asking these governments to deliver," he said.

In early March, Mr. Rajoy defied his European counterparts by softening the country's deficit target. Since then, Spain's long-term borrowing costs have remained above those of Italy, the other large and troubled economy in the euro zone. As he presented the government's plan to reduce its annual budget deficit, Mr. Rajoy also disclosed that the total national debt would rise to 80 percent of gross domestic product this year, from 68.5 percent in 2011.

To help alleviate investors' concerns, Mr. Rajoy is now counting on a €27.3 billion squeeze in the central government's budget for this year. His 2012 budget, introduced last Friday, calls for government ministries to cut spending 17 percent, on average. Mr. Rajoy, who took office only three months ago, is also relying on an amnesty program intended to increase tax revenue by bringing to the surface part of the income generated by Spain's underground economy.

In another sign of the euro zone's continuing fiscal troubles, the Greek track and field federation announced Wednesday that it was suspending all domestic competitions indefinitely as a protest against cuts to state financing. While the action will not affect international events, including Greece's participation in the Summer Olympics in London, it brings to a halt domestic contests planned across Greece, including marathons in several cities.

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It was the second time that the Hellenic Track and Field Federation has suspended operations in recent months. In November, the group suspended its operations for two weeks, but there were few events scheduled at the time. The federation said this suspension was indefinite, but added it would review its decision "depending on developments."

The head of the group, Vassilis Sevastis, said budget cuts meant that the organization had not been able to pay coaches and suppliers for up to 10 months. In a statement, the federation called on Culture Minister Pavlos Geroulanos "to intervene and avert the financial deadlock and the demolition of the backbone of classic athletics."

LOUISA GOULIAMAKI/AGENCE FRANCE-PRESSE

Greek construction workers demonstrated in front of the Labor Ministry in Athens on Wednesday to protest austerity measures and the unemployment in their sector.

Tensions in European financial markets have cooled in recent months after the E.C.B. issued €1 trillion in cheap, three-year loans to banks. Mr. Draghi said the loans provided "a window of opportunity for governments to undertake structural reforms."

But Jörg Krämer, chief economist at Commerzbank, said the money could have the opposite effect, taking the heat off the leaders of countries like Italy to undertake measures that would initially be unpopular, like reducing job protections, but ultimately improve growth.

"The success of the three-year tenders took pressure off the peripheral countries to implement the necessary reforms," Mr. Krämer wrote in a note to clients Wednesday. "But without such reforms the sovereign debt crisis will not be solved and the E.C.B. will be forced t continue to de facto finance peripher countries by printing money."

In what may have been an attempt assuage German fears about inflatic Mr. Draghi made a point of emphasizi that the E.C.B. would keep a close eye o for signs that higher energy prices we translating into higher overall prices.

Mr. Draghi may also have been reac ing to an agreement last week betwee Germany and the union representing two million public sector workers that gives them a 6.3 percent wage increase.

Jens Weidmann, president of the Bundesbank, the German central bank, has been particularly vocal about the need to make sure that measures to prevent a deeper banking crisis do not create an inflationary backlash.

But Mr. Draghi gave no indication the E.C.B. was likely to tighten monetary policy soon. Mr. Draghi said it would be "premature" for the bank to begin rolling back the special support it had been providing to banks.

"The E.C.B. still seems to be prepared to keep its exceptional monetary policy measures in place for quite some time," Peter Vanden Houte, an economist at Dutch bank ING, wrote. "The difficult part will be to keep the Germans in the governing council happy and at the same time putting pressure on peripheral governments not to come back on their promise of fiscal consolidation."

Jack Ewing reported from Nicosia. Niki Kitsantonis contributed reporting from Athens.